Alexander v. Commissioner, 95 T. C. 467 (1990)

The at-risk rules under Section 465 do not apply to new activities unless the Secretary prescribes regulations extending their application.

Summary

The case involved limited partners in computer software development partnerships who sought deductions for partnership losses. The IRS argued that the at-risk rules should limit these deductions due to the partners' promissory notes. However, the court found that the partnerships were engaged in a 'new activity' under Section 465(c)(3)(A), and since the Secretary had not promulgated the necessary regulations, the at-risk rules did not apply. This ruling reversed the court's earlier decision that had followed Jackson v. Commissioner, clarifying that without regulations, Section 465(b)(3) cannot be applied to new activities.

Facts

The petitioners were limited partners in five partnerships involved in computer software development: Blueprint Software, Blueprint Software Professional, Quoin Software, Matrix Business Computers, and Computech Research Investors, Ltd. The partnerships issued promissory notes to finance their activities. The IRS argued that the payees of these notes held interests other than as creditors, thus invoking the at-risk rules under Section 465(b)(3)(A). The partnerships were in their startup phase, developing software, and had not yet produced any depreciable property.

Procedural History

The Tax Court initially held that the at-risk rules applied to limit the partners' deductions, following the precedent set in Jackson v. Commissioner. Upon the IRS's motion for reconsideration, the court revisited its decision. It acknowledged that no final regulations had been issued by the Secretary regarding the application of Section 465(b)(3) to new activities under Section 465(c)(3)(A).

Issue(s)

1. Whether the partnerships were engaged in the activity of leasing Section 1245 property, thus falling under the 'old activities' of Section 465(c)(1)(C).
2. Whether the at-risk limitations of Section 465(b)(3)(A) apply to the partnerships' activities, which are considered 'new activities' under Section 465(c)(3)(A), in the absence of regulations prescribed by the Secretary.

Holding

1. No, because the computer software was not yet developed and thus not depreciable property under Section 1245 during the years in issue.
2. No, because the at-risk rules under Section 465(b)(3)(A) do not apply to new

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activities without regulations prescribed by the Secretary, as mandated by Section 465(c)(3)(D).

Court’s Reasoning

The court reasoned that the partnerships were not engaged in leasing Section 1245 property because the software was in the development stage and not yet depreciable. The court then focused on whether the at-risk rules could apply to the new activity of software development. It found that Section 465(c)(3)(D) explicitly requires regulations for the application of Section 465(b)(3)(A) to new activities. Since no such regulations existed, the court could not apply the at-risk rules. The court also overruled its prior decision in Jackson v. Commissioner, which had applied the at-risk rules to new activities without regulations. The concurring opinions emphasized the need for regulations and clarified that the focus should be on whether the partnerships engaged in any leasing activities, which they did not.

Practical Implications

This decision limits the IRS’s ability to apply the at-risk rules to new activities without regulations, affecting how tax professionals advise clients involved in startup or speculative ventures. It underscores the importance of regulatory action by the Secretary to extend the at-risk rules beyond the specified old activities. Tax practitioners must now be cautious in advising clients on the deductibility of losses in new activities, ensuring they are aware of the regulatory status. The ruling also impacts the tax treatment of investments in emerging industries, like software development, where the asset may not yet be depreciable. Subsequent cases, such as Transco Exploration Co. v. Commissioner, have reinforced this ruling, highlighting the need for clear regulations in applying the at-risk rules to new activities.

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